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A Consideration on International Coordination of Financial Regulations: Implications from Experiences in OTC Derivative Market Reform

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This paper aims to explore possible measures to harmonize or coordinate national regulations better on cross-border financial transactions, deriving empirical lessons from the ongoing discussion on over-the-counter (OTC) derivative market reform, which has been one of the most important agenda at G-20 meetings since 2009. Given that perfect convergence or standardization is not realistic at international fora, to effectively rely on other jurisdictions' regulatory regimes, existing approaches such as mutual recognition or substituted compliance need to be exercised on an outcome basis. Against this backdrop, the author advocates that deepening mutual understanding through closer communication among national regulators in charge is the key to avoiding or minimizing problems arising from extraterritoriality of domestic rules going forward.

Introduction: International harmonization of financial regulations

With the bitter and disastrous experiences in international trade and financial transactions during the interwar period of the 1920s and 1930s, there was a strong consensus among political and economic leaders on the need for international coordination and a rule-based logical and practical framework for international trade and finance, culminating in the Bretton Woods Conference in 1944, which led to the establishment of the IMF and the IBRD, and imperfectly the GATT [Kitamura 2009: 187]. Unlike areas such as competition and trade and telecommunication standards, international harmonization of relevant national rules is an issue of political economy rather than an issue of law.

A treaty provides a legally-binding force consisting of more credible commitments between the signatories. On the other hand, the ratification of a treaty is difficult, time consuming, and costly. As a result, formal legal obligations are most valuable when the potential for opportunism is high and the credibility of commitments is important [Verdier 2012: 17]. Besides, dispute resolution relying on judgment by court is basically not a suitable tool for matters related to financial regulation. As long as the regulator is not content, the problem will remain as non-favored treatment by the regulator towards the foreign financial institution in its jurisdiction. To induce the regulator to amend its regulation voluntarily is the key to successful resolution.

Against this backdrop, statutory agreements dominate in economic fields, resulting in more use of

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the terms "agreement" and "rules" rather than "standardization" or "standards" [Kitamura 2009: 187]. Verdier argues that international financial regulation (IFR) relies not on treaties and organizations, but on "soft law" standards designed by informal networks of regulators, in sharp contrast with other international regimes such as trade. International Organization of Securities Commission's (IOSCO's) Multilateral Memorandum of Understanding (MMoU), the Basel Concordat, and international accounting standards are widely recognized as successful example in this context. These mechanisms which are usually known among academics as Transnational/Transgovernmental Regulatory Networks (TRNs),[1] and soft law, dominate IFR, because they provide some incentives for compliance while preserving the benefits of speed, flexibility, and expertise [Verdier 2012: 2–4].

In most countries, the legislature delegates extensive authority to shape and enforce financial regulation to expert bureaucrats. While in the past this authority was often exercised by a department of the executive branch, the more recent trend has been to delegate regulatory powers to the central banks or to create specialized independent agencies such as securities, banking and commodities commissions. These specialized national regulators emerged as the primary actors in IFR.[2] On the other hand, a setback of TRN is that since specialized regulators are not directly accountable for failures in areas where IFR performs poorly, and they prefer to preserve as much authority and discretion as possible, they have little incentive to strive for a more formal and binding IFR system.

Harmonization of cross-border regulations among individual jurisdictions, including the timing of implementation, is needed for the purpose of preventing regulatory arbitrage, decrease of international transactions and market segmentation, while ensuring a level playing field and investor protection. Extraterritoriality has often been discussed in the context of rules concerning banking supervision by Basel Committee on Banking Supervision (BCBS), bank resolution of financial institutions and accounting standards.

The extraterritoriality of national regulations related to OTC derivatives is a relatively new issue, and it may be too early to try to derive firm lessons from the past discussions and experiences, given that the issue has not been addressed fully at the time of this writing, in late 2013. However, if the underlying problem is not made clear now, a similar problem could arise in other financial areas in the near future.

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[1] According to Verdier [2009: 118], TRNs are informal multilateral forums that bring together representatives from national regulatory agencies or departments to facilitate multilateral cooperation on issues of mutual interest within the authority of the participants. Verdier points out the following characteristics of TRN: their members are not states but specialized regulatory agencies; they are not created by treaty and have no international legal personality; they lack formal assemblies or voting procedures; the instruments they promulgate are not internationally binding; and, at least until recently, they do not systematically monitor or enforce compliance with those instruments. He also names the Basel Committee on Banking Supervision, which is a forum for regulators and central bank governors, as the first major TRN in financial regulation. In addition, he names IOSCO and IAIS as TRNs [Verdier 2012: 12–14].

[2] Verdier explains the reason for this as that under the postwar Bretton Woods monetary system, international capital mobility was expected to be strictly limited and, thus, there was no need for a formal institution to regulate private international finance, alongside the ones established for monetary affairs and trade. With no international framework to address them and no authority to create formal institutions or binding agreements, they instead created informal networks and non-binding standards. For better or worse, this approach remains the cornerstone of the current system [Verdier 2012: 4].

International guidelines, including recommendations and principles, are not legally binding and do not require jurisdictions to amend their laws or regulations for compliance. They can be ineffective, subject to powerful domestic constituencies. “Principles for Financial Market Infrastructures” (PFMIs) (http://www.bis.org/publ/cpss101a.pdf) published by Committee on Payments and Settlement System (CPSS) and IOSCO in April 2012 is most frequently referred to as such.

Similarly, IOSCO’s “Principles regarding Cross-Border Supervisory Cooperation” (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD322.pdf) published in 2010 is the international guideline most relied on with respect to cooperation issues among regulators. However, from a practical viewpoint, TRN is virtually binding through peer review and implementation monitoring by international organizations, such as Financial Sector Assessment Program (FSAP) conducted by IMF and World Bank, as well as peer review conducted by Financial Stability Board (FSB).

Another advantage of soft law agreements is that they are easier and faster to conclude, because they do not require cumbersome domestic ratification procedures. Since they are negotiated by experts rather than politicians, technical questions can be resolved based on shared expert knowledge. Since they are not legally binding, they provide flexibility to adjust the obligations as circumstances change. Soft law works well for securities regulation because it provides speed, flexibility and experience in regulating ever-changing markets.

On the other hand, treaties require the involvement of the ministry in charge of foreign affairs, which makes the process time consuming in some jurisdictions. A weak point of soft law is that governments could adopt a strategy of “mock compliance”—formally adopting the standards while ignoring them in practice. As regards this argument, some advocate that IFR has significant coercive power because pressures from markets and IFIs compel states to comply, and regulators wish to protect their reputation vis-à-vie their peers.

Implementation monitoring and assessment is based on the expectation of practical binding force through peer pressure and the “name and shame” effect which arises from publication of assessment results. As Chris Brummer argues, soft law can become more authoritative when combined with other costs such as reputational cost [Brummer 2012: 274]. The actual success of IFR initiatives depends on the respective interests and capabilities of these actors, which is the case when they have strong support from at least one, and passive acquiescence by the others in most circumstances. In this respect, the most difficult post-crisis challenges—tackling systemic risk and moral hazard—fall precisely in the area where IFR has historically performed poorly [Verdier 2012: 4–20].

The author explains in Chapter 1 what factors make OTC derivatives transactions so special as to remain frequently discussed agenda at the G-20 leaders’ level and how the OTC derivatives regulatory reform has developed so far. Chapter 2 delineates the mechanism of how the mutual recognition works as the currently existing most practical approach to address cross-border issues. Chapter 3 aims to present implications derived from the international discussions on OTC derivatives regulatory reform and some possible way forward. In the conclusion, the author describes key messages and possible measures to prevent the occurrence of similar lingering conflicts among financial regulators of the world to the extent possible.

1. Characteristics of cross-border OTC derivatives transactions

Cross-border conflicts can easily take place in the financial world. A well-known example might be the case of an international bank resolution which often crystalizes the home-host issue. Of all the agendas taken up by the G-20 leaders after the global financial crisis, the most significant and contentious one has been OTC derivative market reform.

Derivatives are financial instruments used for both risk management and speculation. Derivatives are an essential risk management tool for many firms. Without them, firms would be left without a method for hedging against risks beyond their control and would be discouraged for entering into economically useful activities. Eliminating the use of derivatives would be akin to denying firms the right to acquire insurance on certain deals.

Given the cross-border nature, it is critical for regulators that a large portion of the derivatives transactions has been dealt over the counter of the trading firms on a customized basis in accordance with individual risk profiles of their clients, and not traded at exchanges. This makes it extremely difficult for regulators to grasp a global picture of OTC derivatives market configuration, and highly likely that they overlook the pile-up of exposures hidden from the public eye, to a fatal extent from the viewpoint of of managing systemic risks, which has been the most important mandate under globalization today.

The causes for the global financial crisis of 2008 were complex and many. However, a commonly accepted — and easy-to-follow — narrative is that loan originators sold vast amounts or risky loans that were then repackaged (securitized) and sold off to the investors, who — for one reason or another — were unaware of the creditworthiness of the borrowers. The misuse of certain complex derivatives has been blamed for causing the financial crisis by increasing the amount of risk in the financial system and concentrating it in certain systemically important entities [Turner 2012: 398–402]. OTC derivative market reform is a notable example of jurisdictions rushing to develop new rules both without detailed international guidelines and without time for coordinating with each other.

After the global financial crisis, G-20 leaders decided that OTC derivatives transactions should be traded either at exchanges or electronic trading platforms (ETPs), cleared by central counterparties (CCPs), and reported to trade repositories (TRs), with the aim of enhancing transparency, eliminating market abuse and mitigating systemic risk. Almost no jurisdiction had relevant rules at that time. At the G-20 Pittsburgh Summit in 2009, leaders committed to conducting OTC derivatives regulatory reform.[3]

Since then, G-20 countries have had to introduce new rules and amend existing ones under severe time constraints for coordination with other countries in a hasty manner. This resulted in the current

[3] For example, text of the G-20 leaders' statement is available at http://ec.europa.eu/commission_2010–2014/president/pdf/statement_20090826_en_2.pdf.

situation that some of the G-20 member jurisdictions have unique rules on the essential part of the G-20 commitment (e.g. mandatory clearing at CCPs) different from each other. For instances, lawmakers in the United States and Europe introduced two major pieces of legislation designed to harmonize U.S. and European financial regulations, including the regulation of OTC derivatives. These were the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the European Union's so-called European Market Infrastructure Regulation (EMIR).[4]

As a result, national laws and regulations developed in different directions. Due to the heavy burden of amending those rules once again, regulators are reluctant to change their own rules, and a deadlock situation is being observed, leaving the G-20 commitment unaccomplished. When applying its own rules in an extraterritorial manner, the regulator needs to coordinate with its counterpart regulators appropriately in terms of the scope of entity and product for application as well as the basic approach used. Against this backdrop, cross-border coordination or harmonization has always been one of the most discussed agenda at the G-20 Summit meetings, up to the latest one in St. Petersburg in September 2013.

As the former Chairman of the US SEC argues, a holistic approach to consider cross-border securities transactions was not needed from a practical viewpoint. In sharp contrast to that, the multi-trillion dollar OTC derivatives market became a significant market well after the advent of global trading—exploding in size over the last 20 years, operating relatively seamlessly across jurisdictions, and evolving largely without regulatory restraints. Today, cross-border derivative transactions are not the exception but the norm [Walter 2013].

Therefore, once regulations are implemented across the major derivatives jurisdictions, the majority of derivatives transactions could be subject to multiple regulatory regimes. The potential for conflict among those regimes is obvious. Facing the impending threat of contradictory rules, market participants have the ability to move or restructure their OTC derivatives activity with relative ease, avoiding more regulated markets, in search of less regulated ones.

After all, derivatives are contracts between counterparties—they need not be anchored to any particular geographic location or market. Thus, cross-border OTC derivative transactions are the norm. In fact, although other securities and financial products are also traded beyond jurisdictions, the volume of OTC derivative traded on a cross-border basis is much bigger than those.[5] Extraterritoriality is an issue caused by cross-border application of national rules. It is recognized that there are four types of forms problem can take as a result of extraterritoriality of national rules (see the box below).

Besides, the necessity to regulate the OTC derivatives transactions was sensed by policy makers and raised acutely and hastily. For instance, laws in the US and EU stipulate that cross-border OTC derivatives transactions which have direct and significant connection with their economies should be subject

[4] Kono [2013] delineates the initiatives taken by standard setting bodies, as well as efforts made by regulators of major OTC derivatives jurisdictions, to fulfill the Pittsburgh G20 leaders' commitment on OTC derivatives market reform.

[5] Data on transactions volume of OTC derivatives (notional principal basis only) is provided by the Bank for International Settlement and updated semi-annually and available at http://www.bis.org.

BOX: Types of Problems by Extraterritoriality

Conflicts	Conflicts in national regulations arise when the rules of one jurisdiction cannot be followed without contravening a requirement in another jurisdiction.
Inconsistencies	Inconsistencies exist where requirements apply to certain products or participants in one country but not in other countries. They increase the cost of compliance, which may prevent the execution of certain transactions and hamper risk management.
Overlaps	Overlaps in national regulations occur when a transaction or market participant is subject to duplicative obligations across jurisdictions, which increase compliance costs.
Gaps	Gaps are instances where a transaction or participant not regulated by any jurisdictions encourages regulatory arbitrage and increases financial system risk.

[Carney 2013: 15]

to regulatory requirements. Once these rules are fully implemented, firms will not be able to conclude deals lawfully without consistency of corresponding rules among jurisdictions.

In order to address such a cross-border issue, regulators of relevant jurisdictions established an inter-agency forum named OTC Derivatives Regulators Group (ODRG) and has been reporting the outcome of its discussions to FSB and G-20 regularly.[6] Regrettably enough, at the time of this writing, in late 2013, international concern on potential conflicts, inconsistencies, overlaps and gaps of domestic requirements remains substantial.[7]

For example, scopes of mandatory clearing at CCP are differently stipulated in domestic laws and regulations from jurisdiction to jurisdiction with respect to the entity (e.g. branches of OTC derivatives dealers) and product (e.g. commodity based derivatives), as well as registration/licensing requirements for dealers and market infrastructures including ETPs, CCPs and TRs. The same situation of diversification is the case with the timing of implementation of the relevant national rules.

Under these circumstances, legislative and regulatory uncertainty is beginning to have a negative influence on international transactions of OTC derivatives. Out of the anxiety of breaching foreign regulations unintentionally and getting punished by the competent foreign authority going forward, some international OTC derivatives firms have been reportedly refraining from making deals with foreign entities in certain jurisdictions.

[6] Some of the reports to G-20 are available publicly on the websites of member regulators. The latest report at the time of this writing which is entitled “Report on Agreed Understanding to Resolving Cross-border Conflicts, Inconsistencies, Gaps and Duplicative Requirements” is available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/odrgreport.pdf, etc.

[7] For information on the latest status of the issue at the time of this writing, see the above mentioned ODRG‘s report to the G-20 and FSB OTC Derivatives Working Group’s (ODWG’s) progress report entitled “OTC Derivatives Market Reforms—Sixth Progress Report on Implementation—” (http://www.financialstabilityboard.org/publications/r_130902b.htm).

2. Recognition of other jurisdiction's rule

Tai-Heng Cheng acknowledges that international regulatory prescriptions are most likely to be effective when they do not require national policies to change [Cheng 2012: 198]. Given the great divergence of international society which arises from particular situations each country faces, it is not practical to aim at a perfect convergence of national rules.

Rather, we should pay due respect to such differences. In this regard, recognizing other jurisdiction's rules as equivalent to own rules, as far as certain conditions are met, is perceived as the most practical approach at the present. Determination of equivalence or comparability of the counterpart's rules is the key element for this tool. There are some elements to be considered in this respect as described below.

In a mutual recognition system, two or more states agree to recognize the adequacy of each other's regulation as a substitute for their own. Accordingly, firms or activities that comply with their home state's regulation may access the host state pursuant to an exemption from some or all of the host state's regulatory requirements. Mutual recognition differs from harmonization, which involves a systematic effort to eliminate substantive differences between countries' regulatory requirements, usually by amending them to conform to uniform international rules.

Instead, mutual recognition rests on an assessment that the home state's regulation is "equivalent" or "comparable" to that of the home state, and vice versa.[8] Mutual recognition is often referred to as "substituted compliance" and is not a universally perfect solution, as originally advocated by high-ranking officials of the US SEC [Tafara and Peterson 2007], but it provides the most practical mechanism to address the cross-border issue of regulatory coordination in the current real world, which often lacks a firm yard stick such as a treaty.

As Verdier maintains, mutual recognition is founded on a promise of reciprocal market access that may harness a constituency of financial services "exporters" to provide domestic political support for new agreements [Verdier 2011: 66]. In this regard, reciprocity based on the principle that one will recognize comparability of the other's rules only to the extent the other recognizes the comparability is the key. This approach entails a process to compare different legal and regulatory systems in a comprehensive manner. Thus, it can be very time and resource consuming, especially when it is conducted parallel among more than three jurisdictions.

Although international principles fail to provide detailed guidelines due to its flexible nature to be applied to various jurisdictions, they can be a high-level yardstick to be respected when conducting comparability assessment in an outcome-based manner. International standards such as CPSS-IOSCO's PFMIs are often very general in nature, and were not designed to cover all concerns a host state may have about matters. Obviously, however, insisting on identical regulation as a prerequisite to mutual recognition would make it tantamount to harmonization and defeat its purported benefits.

[8] Refer to Verdier [2011] for details on mutual recognition.

Mechanical comparison of corresponding languages can only result in the determination of no-equivalence or comparability, which can force one of the concerned parties to change their ready-finalized national rules. Based on the recognition, Tafara and Peterson suggest that the assessment is to be made at a more general level, emphasizing the similarity of objectives between the systems and comparisons of certain "core" regulatory requirements [Tafara and Peterson 2007: 59–61]. Sometimes, it can be appreciated as a good effect of mutual recognition to promote regulatory competition, which may be a useful check on inefficient national systems and allow individual states to serve as laboratories of regulatory innovation [Verdier 2011: 65–94].

However, there is no guarantee that such competition would be made in an appropriate manner, given the power gap among jurisdictions. Ultimately, what matters most for market participants is whether or not the equivalence of their home countries' rules concerned is determined by foreign authorities of the jurisdiction where they are doing business. In this context, the approach of mutual recognition is not useful especially to address the case of regulatory gaps, as it relies on the existence of similarity among regulations, if not identicalness.

In order to fill such gaps, competent authorities of each relevant jurisdiction need to adjust their domestic rules to a common yardstick. Comparability assessment requires high level similarity between relevant regulatory regimes, and where such minimum similarity lacks, there may be no other choices than applying stricter rules for the purpose of avoid regulatory arbitrage.

Granting exemption is a form of substituted compliance or mutual recognition, as far as it is based on equivalence or comparability. As Professors Jerry Ellig and Houman Shadab have argued, mutual recognition agreements should be "outcome-based." Under this approach, domestic regulators would not focus on the similarity of regulatory prescriptions, but on whether foreign regulatory systems achieve comparable outcomes (e.g. investor protection). This approach has the benefit of acknowledging that there is no one-size-fits-all solution to such complex problems as the cross-border issue on OTC derivative regulation [Ellig and Shadab 2009: 323].

Mutual recognition would permit regulators to agree only to basic, minimum standards, while adopting their own detailed answers to these and other questions to suit their domestic policy preferences and the demands of domestic constituents [Turner 2012: 422]. Although it is not within the scope of analysis of this article, it should be noted that the system of mutual recognition does not necessarily lead to the objectively desirable result of coordination, reflecting the power balance among jurisdictions concerned (e.g. size of their domestic markets and political bargaining power).

3. Towards better coordination among regulators

Regulators have been making strenuous efforts under the difficult circumstances that the global financial crisis allowed the regulators little time for coordination among themselves when developing their rules on OTC derivative transactions. Nevertheless, the current situation leaves much to be desired. There is no such thing as a "one-size-fits-all" approach to address this issue, due to economic, political and social specificities in each jurisdiction.

For instance, regulators are independent of government in some jurisdictions and not in others. Some regulators are responsible only for investor protection and market integrity while others are responsible also for economic growth in a practical sense. Nevertheless, it does not exclude the room for regulators to learn frankly from each other for the ultimate regulatory goals of market integrity and investor protection in the global financial markets.[9] In this regard, it is beneficial that regulators accept the best practices of their colleagues in other jurisdictions on a voluntary basis. The important factor to be considered is that regulators do not feel forced or pressed in any sense to change their own rules by others.

To establish a cooperative and even friendly relationship which enables regulators to know more about each other, including their entire legal and regulatory framework, is the prerequisite for such enhanced coordination among regulators. For this goal, it might be worthwhile considering to share with each other even failure experiences. Regulators could sometimes learn more from failure than success.

Realization of conflicts which can result in the segregation of the global OTC derivatives market and a decrease of liquidity in the market is currently only avoided by time-limited relief, such as exemptions of extraterritorial application or deferral of implementation, which is announced by no-action release of own rules. Under the circumstances there is little outlook for reaching agreement in a timely manner. However, such a measure can be nothing but a tentative solution to save time until an ultimate solution is agreed.[10] In practice, this was the only way to avoid realization of potential catastrophe.

On the other hand, there is a dilemma that it means a further delay of fulfillment of the G-20 leaders' commitment at Pittsburgh in 2009. Harmonization is costly, once rules are set in jurisdictions in such forms as statutes and acts. Someone must pay a high price for amending the laws or regulations, which entails a very tiring and time consuming process. Thus, it implies that the starting point is critical. Coordination and information sharing from the very early stage is the key to prevent extraterritoriality.

A contingency plan for financial institutions needs to be developed as a back stop for the case that coordination among authorities doesn't work. Coordination at a higher level seems indispensable. It

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9 In general, the most challenging task for regulators is to strike the proper balance between the twin objectives of ensuring the safety and soundness of the financial system and of fostering the growth and development of the financial markets. As for the latter, an unattractive market will cause the movement of financial activity to other markets. In this regard, financial markets are in competition with each other. Excess competition between financial markets could bring about conflicts of interest for regulators and, as a result, hamper cooperation among regulators from a bad viewpoint that supporting regulators in other jurisdictions would simply lead to losing relative dominance in your own market. As Pan points out, to the extent that national regulators operate independently of one another, they will always face competitive pressure and must be prepared to implement regulatory strategies that make their markets more attractive. If we believe such competition undermines the stability of our financial markets through the "race to the bottom" approach, the solution is to improve cooperation among national regulators to minimize the differences in national regulation and supervisory standards [Pan 2011: 800–812].

10 For instance, CFTC has decided to delay the application of its cross-border rules in July 2013. EC also delayed the deadline for ESMA's technical advice on equivalence between EU regimes and those of other jurisdictions in June 2013. Other jurisdictions are taking similar measures, including refraining from applying their rules cross-border.

has already become an important political agenda and pressure from the ministerial level is needed to move things forward. However, it may not be effective enough, where some agencies are even independent of the supreme leader of the jurisdiction they serve. From the realistic viewpoint, a combination of harmonization and other tools, including mutual recognition/substituted compliance and exemption is the only practical way forward, although it is far from a perfect solution.

In order for the comparability/equivalence assessment to be successful, relevant regulators should basically refrain from requesting legislative and regulatory changes from each other. In this regard, relevant regulators need to communicate with each other very closely both at the institutional level and individual staff level through various channels. As regards the latter, frequent and in-depth exchange of views not only among high rank officials of the relevant authorities but also among practitioners is very useful.

The outcome-based approach for equivalence/comparability assessment requires a deep understanding of the ideas underlying each other's regulatory regime, unlike the simple rule-by-rule comparison. A mutual secondment of staff in charge of planning regulations of OTC derivatives would be worth considering. Below are two measures the author finds most practical and effective to address cross-border regulatory conflicts. In practice, there is no one-size-fits-all approach, and an effective approach could be different depending on individual situations. Therefore, all possible combinations of all possible approaches should be tested to find a globally consistent solution.

3.1 Stronger involvement of international standard setters

Discussions at international conferences of standard setting bodies (SSBs) and steering by SSB has been the main driving force to bring about agreement and to find solutions to tough issues. Still, there may be some room left for wielding even stronger influences. National regulators are increasingly coordinating their actions through intermediary organizations designed to facilitate a higher level of multilateral action.

Examples include the BCBS, the IOSCO, the CPSS, and Committee on Global Financial System (CGFS). These entities each provide a forum in which national regulators can interact and serve a vital function in the monitoring and appraising of member's efforts to adopt relevant prescriptions. Coordinating agencies accomplish their work by issuing best practices and standards, publishing expert reports, and providing opportunities for information sharing and the coordination of enforcement across borders [Turner 2012: 410].

There always exists a trade-off between respect for sovereignty and regulatory efficiency and transparency. The main drawback of informal agreements relative to treaties is that, since the reputational costs and enforcement mechanisms are weaker, informal commitments are less credible and less likely to constrain opportunism by states. However, states often favor informal agreements in areas where uncertainly is high because they retain more flexibility to modify the agreement in light of changed circumstances. States may choose to interact through networks in complex regulatory areas where speed, expertise, and flexibility are essential, and many issues can be addressed through simple coordination [Verdier 2009: 167–172].

SSBs may find themselves in a better position also from the viewpoint of achieving the ultimate goal of international financial society to serve fair and efficient market conditions, being free from political pressures (or under weaker pressure at least), given that coordination among national regulators can not ensure the optimal solution for the global financial market as an entirety. Speediness/timeliness is the key in any sense. Desirably, international guidance should be published before jurisdictions decide their cross-border policies in order to avoid a backrush afterward.

Better representation of stake holders would be required. In the case of OTC derivatives market reform, the fact that the European Commission, which is responsible for the ultimate decision on equivalence of other jurisdictions' legislative and regulatory regimes, is not a member of IOSCO, unlike European Securities and Market Authority (ESMA), might be pointed out as a reason why the SSB could not play a leading role in coordinating relevant national agencies in a direct manner. BCBS issued its "Core Principles for Effective Banking Supervision" and IOSCO did its "Objective and Principles of Securities Regulation".

Needless to say, G-20[11] is not a TRN; it is a political body made up of the national leaders (or ministers and central bank governors) of the member states. However, it is not a formal international organization either. Like most of the existing TRNs, the G-20 does not have an international legal personality, its decisions are made by consensus, and they are not legally binding. But collectively its members' financial regulators dominate the principal TRNs, and therefore the G-20 has the capacity to exercise an enormous influence on IFR.

The top-down approach taken by the G-20 following the financial crisis is an example of legal convergence. Convergence, or harmonization, occurs when legal systems become more similar to one another, usually through the deliberate adoption of policies. In international law, this approach is notable because it places the onus for implementing shared prescriptions on national governments, without formally obligating them to do so. In other words, the recommendations adopted by the G-20 at its recent summits are just that: recommendations that member states can adopt or discard at their will.

G-20 reorganized the Financial Stability Forum, which was established by the G-7 in 1999, as the FSB, with a broader mandate and membership, including all G-20 members. Its mission is to coordinate and oversee the work of other SSBs. The G-7 took over a more active and detailed priority-setting role for international financial regulations. The G-20 was created at that time to give a voice to leading developing countries.

[11] G-20 is an association of finance ministers and central bank governors from nineteen nations and the European Union whose origin lies in the financial crisis of the late 1990s, which was created after the Asian financial crisis but played a marginal role, supplanted the G-7 as the principal forum for international economic cooperation. G-20 members meet periodically to confer on issues related to national policies, international cooperation, and international financial institutions with the aim of supporting growth and development across the globe. For further information on G-20, see "What Is the G-20?" (http://www.g20.org/index.php/en/what-is-the-g20).

The G-20 is another example of an organization that plays a role in the formulation and promulgation of soft international law. Much of its work is carried out through the FSB. The FSB was created at the G-20's London summit in 2009 with the mission to "give momentum to a broad-based multilateral agenda for strengthening financial systems and the stability of international financial markets" through actions that include assessing member nations' financial systems and regulatory structures, coordinating the exchange of information among members, and promoting necessary reforms.

The FSB is "a network of networks" and also interacts with key organizations, including BCBS, IOSCO and CPSS. Among the FSB's contributions to the G-20's efforts is the issuing of progress reports on subjects, including reforms to the over-the-counter (OTC) derivatives markets [Turner 2012: 410]. Basically, G-20 is not a proper stage to discuss technical issues in the financial area, but could further work as an entity which can add political pressure to international negotiations among regulators and expedite them when there is little progress being made by regulators themselves.

3.2 Improving communication between regulators

Above all, dialogue is needed among regulators. In order to assess the comparability or equivalence on an outcome basis in a holistic manner, which means that some minor incomparability could be ignored when determining equivalence, it is essential for regulators to develop mutual understanding. In this respect, the best teacher is the counterparty regulator. In other words, a lack of a deep understanding of each other's regulations tends to end up with superficial equivalence assessment on a rule-by-rule basis as an easy solution.

In reality, the great economic powers disproportionately influence outcomes. Thus, interstate power relationships also matter to IFR. They are reluctant to support the creation of binding international standards and centralized institutions, because a more fragmented system allows them to wield their power more freely and achieve their objectives by shifting the issue to the most favorable forum [Verdier 2012: 22–29]. As is often argued by academics, uniform prudential standards only succeed when several major jurisdictions face similar crises at the same time, and are willing and able to compel others to join.

Regulators have been exchanging views through various channels, including email, phone and mail, as well as in-person meetings. Still, more frequent regular meetings among principals of relevant regulators would be useful. In this respect, the central bank community is in an advanced position with respect to the frequency of top level meetings. There are a lot of similarities between central banks and regulators, especially in activities such as rule-making. But, roughly speaking, central banks are freer in nature than regulators, which are more restrained by laws and own regulations.

In the central bank society, Bank for International Settlement (BIS) located in Basel serves as a hub for communication. BIS hosts two principal bimonthly meetings: Global Economy Meeting, which comprises the governors from 30 BIS member central banks in major advanced and emerging market economies that account for about four fifths of global GDP, and All Governors' Meeting, which comprises the governors of the BIS's 60 member central banks (BIS 2013: 83–84). These regular meetings among central bank governors can be a model for regulators with respect to regularity and frequency at least.

As such, securities regulators set up a high-level meeting of ODRG in 2011. But ODRG meetings have not been so frequent and only on an ad-hoc basis so far [ODRG 2013]. To regularize meetings among principal regulators could be a first step to enhance communication among OTC derivatives regulators. IOSCO adopted MMoU in 2002 for the purpose of strengthening cross-border assistance. All IOSCO members are expected to sign the MMoU, which requires prior screening to ensure that they have in place the necessary domestic authority to comply with assistance requests. The supervisory MoU relies on the signatories' supervisory regime and is useful in ensuring enforcement.

Regulation is closely linked to supervision activities over financial institutions on compliance with relevant rules, including regulations. Regulators also conduct supervision in many cases. PFMs' Responsibility E stipulates cooperation among authorities, including regulators. But, it provides too little additional guidance on cross-border cooperation for practical use.

Conclusion

The lessons the author derived from the OTC derivatives market reform could be summarized as follows:

a) a. jurisdictions should coordinate with each other before finalizing their own national rules; and
   b. regulators should have a profound understanding of the philosophy of corresponding legal and regulatory frameworks in other jurisdictions.

Based on the above basic findings, measures which the author advocates to be taken are:

b) a. IFRs develop international standards as quickly and in as much detail as possible; and
   b. jurisdictions establish and maintain an effective mechanism for close communication, including personnel exchange, based on written agreements, such as MoU (Memorandum of Understanding) and MoC (Memorandum of Cooperation).

In the case of coordination of financial rules, it is more important to reach an outcome relevant authorities can mutually agree with than winning a case at court, from the viewpoint of protecting national interest. The reason behind this is that one's financial institution could be bullied by the foreign regulators abroad at the end of the day, if they are not content with the judgment.

No mechanism can solve any problem by itself. How can effectiveness and efficiency of the mechanism be ensured? More specifically speaking, how could the outcomes of regulations be compared? Unfortunately, we are not living in a perfect world, and without reliable statistics on OTC derivative transactions that are expected to be reinforced through further development of TRs and their data dissemination system to enable acquisition of the global picture of dispersion of exposure, it is technically close to impossible to seize the outcomes of regulations in a quantitative manner.

From a practical perspective, all alternatives would be tried for breakthrough of dead-lock situations. While discussing the overall direction of convergence at SSB, jurisdictions concerned are expected to negotiate on a bilateral or multilateral basis, using the method of mutual recognition based on equivalence or comparability. In any case, the key is that relevant regulators communicate with each other very closely through meetings both at a high-level and staff level. Given that the outcome-based approach for equivalence/comparability assessment requires a good understanding of the ideas underlying each other's regulatory regime, contrary to a simple rule-by-rule comparison, intense exchange of views on a regular and frequent basis is essential.

At the end of the day, repetitive and patient dialogues among regulators are the only practical solution for this extremely complex problem. Mutual trust is the key word in this respect. Unlike a mechanical comparison of corresponding languages, an outcome-based equivalence determination requires a profound understanding of the counterparties' legal and regulatory regimes.

From a practical viewpoint, no regulatory agency in the world has enough resources to scrutinize other jurisdictions legal and regulatory systems thoroughly. Otherwise, such process as equivalence assessment could easily be self-righteous or excessively dogmatic. In this regard, close and perpetual communications among regulators at various levels are indispensable to ensure reliable information sharing, which only enables fair assessment of others' regimes. Close and long-term relationships among regulators are the source of the practical binding force and have the most effective deterrence power against extraterritoriality that other jurisdictions can not accept.

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